Caron's Corner Transcript – 2.5.2024

The BEAT Monthly: Our Top Four Ideas

- The probability of a soft-landing along with a no-landing scenario is increasing.
- Inflation is declining, but central banks are patiently waiting to cut once they are more assured that the fall in inflation will become anchored.
- What will give them this assurance is a further drop in wage inflation.
- It all comes down to the textbook definition of the Philips Curve relationship between wages and inflation, which sits at the heart of the Fed's economic models.
- In the meantime, we wait. While we do, there are a few changes to our February asset allocation framework that we highlight in this audiocast.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. The probability for a soft-landing along with a no-landing scenario is increasing. The data seems to be moderating as expected, inflation is declining and central banks are patiently waiting to cut once they are more assured that the fall in inflation will become anchored. What will give them this assurance is a further drop in wage inflation and I think this is a key point to focus on. It comes down to the textbook Phillips curve relationship between wages and inflation, which sits at the heart of the Fed's economic models. In the meantime, we wait. While we do, there are a few changes to our asset allocation framework for February that we'd like to share with you.

The first one is bank loans. We are moving bank loans from a neutral to overweight, diversifying our high-yield exposure by increasing our weight in bank loans. We are increasing our weight to the lower credit quality sectors of fixed income in order to potentially capture higher carry and reduce duration exposure in what we believe will be a rangebound market for interest rates. Why? Well, the number of Fed cuts is being debated, but at the same time, recession and default risks remain benign. We maintain an overweight to traditional high yield but instead of adding to that asset class, we are diversifying by increasing our exposure to bank loans.

Let's discuss cash. We are neutral on cash, but are reducing our exposure here to fund carry strategies. We think it is time to reduce cash in 2024 and use it as a funding source, not as an investment. Inflation has likely peaked, policy rates may decline in the quarters ahead and cash may be a drag on performance relative to carry in income strategies that have the potential to add price return. In addition to yield, we moved our portfolio duration target from 3 to 5 years nearing neutral levels.

With respect to emerging markets (EM) hard currency debt, we are moving from neutral to overweight, as we expect spreads and rates to support total EM hard currency debt returns. The Fed "put," now clearly in place, has reinforced an environment of low inflation, lower funding costs and stronger growth. The macro and market environment should ultimately skew spreads toward stability and tightening.

Let's now turn our attention to private markets. In short, I think there are some interesting things going on in this space. While we are neutral, we do see selective positives, and this is all underpinned by higher rates. Investors are experiencing the first industry-wide price correction in private markets since the global financial crisis (GFC), and repricing in private equity is a slow, gradual process. While capital markets activity is thin, a condition that is likely to adjust as relatively cheap debt matures. However, this valuation reset has already occurred more extensively in certain asset classes and market segments offering leading entry opportunities.

One of those is in real estate. The industrial and residential markets have started to reprice, despite continued robust demand and dwindling future supply, providing solid growth potential. On the other hand, defensive and relatively duration-sensitive assets such as triple-net-lease properties now offer constructive valuations and the potential for high stable income. Elsewhere in private markets, we continue to have conviction in the prospects for special situations private credit lenders that are commanding a premium as the supply of opportunities has expanded, but demand from investors has not fully responded.

Moving on, let's now look at a few critical points that we're focusing on. One of the things that we have to note is that there has been a little bit of a pullback from a pull forward of returns that we got at the end of 2023. So yes, the markets are doing well, but we have to remember that the starting point for this year was that the end of 2023 was actually really strong. So even though markets are performing reasonably well, if we look at the year-to-date returns, it's a little bit of the starting point issue just because the performance was so good by the end of the year. That being said, we do think that the trend continues in 2024.

Carry strategies are interesting to us. As we start to think about lower default risks, a more stable economy and a softer landing scenario, we still think interest rates are likely to stay in a range. We do think that the Fed is cutting interest rates, yes, but maybe six cuts are too many. Powell was discussing the potential of three rate cuts this year, maybe four. But the point here is that it's very likely that rates are going to be more stable and start to decline, a good environment for carry strategies.

In terms of the bond and equity relationship, we think that bonds are likely to drive stocks. As the old saying goes, stocks need bonds, but bonds don't need stocks. What this means is that equity market performance is generally more reliant on movements in interest rates, more so than bond returns rely on equity performance. In this instance, we think that if bond yields rise, that could be because bond markets are responding to good economic news. So therefore, interest rates moving higher, which should also be somewhat supportive for equities as well. So we do think there is a lot of information to be gleaned from the bond market in terms of how that translates into equities.

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